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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

No. 675

THE DETROIT EDISON COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF FOR PETITIONER

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Respondent in his brief predicates his case basically upon the argument that Section 23(1) of the statute, which provides for depreciation allowances, presupposes (a) "that the claimant actually *suffer* depreciation—that is, that the burden of the economic loss due to the exhaustion, wear and tear of the property actually be borne by it" (p. 9) and (b) that no such loss is suffered by a claimant unless it "has made a capital investment in the property" (p. 12). Because in the present case "the very purpose of the arrangement made by taxpayer with its applicants is to relieve taxpayer of the burden of making an investment of its own capital" (p. 14), respondent argues that petitioner has made no capital investment in the line extensions and that it therefore suffers no present loss and is entitled to no depreciation deduction. He cites authority for the proposition that a taxpayer must have an economic or beneficial interest in

order to be entitled to depreciation; but that proposition does not help him here. He is forced to go further and contend that the economic or beneficial interest must have been acquired by the taxpayer through an investment out of its own pocketbook; but as to that his position is unsound, as the statute is to the contrary.

(1)

Either the receipt of a contribution and the subsequent construction of a line extension must be treated as severable transactions, each standing on its own feet for tax purposes, or the two must be telescoped and the situation regarded as in substance the same as if the line extension had been constructed in the first instance by the applicant and had then been contributed to petitioner in lieu of cash.

If the former view is adopted, then petitioner, as urged under Point I of its main brief, has a cost of the line extension and therefore a capital investment therein equal to the amount expended on its construction. It built the extension, using its own general funds for that purpose; and where it obtained the funds, whether from earnings, loans, capital contributions, gifts or otherwise, is wholly immaterial. The contribution stands on its own feet. Under this view, respondent's entire argument falls.

If, on the other hand, the contribution and construction are so interrelated that they must be put together as one transaction, the transaction being in substance the same as if the extension itself had been contributed, then, though the petitioner admittedly has personally made no capital investment therein, under the statute it steps into the contributor's shoes and is given the right to use as its own

the latter's capital investment. In this view, Section 113(b)(1)(A) could not possibly be applied to reduce the "basis (unadjusted)" of the extension by virtue of the receipt of cash. There is no preexisting basis to adjust, since the transaction simply amounts to a contribution of the extension itself and the passage of cash is disregarded as a mechanical detail. And for like reasons Section 113(a)(8)(B), relating to basis of property received as a contribution to capital, could not possibly be considered inapplicable either because "the customers did not transfer the facilities themselves to the taxpayer" (p. 25) or because "if the company had failed to construct the facilities in question, the consumers would doubtless have been entitled to a refund of the entire amount of the contributions" (p. 26).

Respondent's argument in this regard is inconsistent and begs the question. In arguing that petitioner made no capital investment, he emphasizes the importance of substance over form, ignoring Point I of petitioner's brief, contending that the fundamental purpose of the arrangement was to avoid a capital investment, and saying that whether the contributions were received before construction or afterwards, as in *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628, cannot alter the substance of the transaction. Yet he refuses to accept the logical consequences of his own argument—that the situation is in substance the same as if the line extensions had been built by the prospective customers and had then been contributed to petitioner in lieu of cash. Inconsistently, he urges the applicability of Section 113(b)(1)(A) to the receipt of the cash, and the inapplicability of Section 113(a)(8)(B) because cash and not property was contributed and because the contributions

were tied up with the construction and would have to be paid back if construction had not ensued.

It is immaterial to the petitioner which view is adopted. For the status of the cash contributions, though unimportant if tested separately, must be precisely the same as if the property itself had been contributed for the identical purpose; and under either view, we come to the same result: petitioner's basis for depreciation under the statute is the amount expended on construction.

Petitioner's rule No. 5, on file with the Michigan Public Service Commission and printed on the reverse side of the regular line extension agreements, Exhibits I and II (R. 21, 25), expressly provides for two alternative procedures to accomplish the same result. It provides that "the applicant for service may build the line extension for the same at his cost, according to the Company's specifications; or may employ the Company to build the same at his cost, payable in advance; and in either such case the Company will refund to the applicant", etc. Instruction No. 3, printed on the face of these agreements, calls for their use under either alternative, with simply the addition of a proper rider if the contributor elects to build. The real substance of the transaction is the same whichever alternative is adopted, and surely the tax consequences must be the same regardless of the mechanical procedure used.

The decisions and rulings dealing with the non-taxability as income of such contributions and subsidies reach the same result whether the contributor first built the property and then contributed it (see *e.g. Liberty Light & Power Co.*, 4 B. T. A. 155; *Rio Electric Co.*, 9 B. T. A. 1332) or whether he contributed cash for construction of the property and the recipient built it (see *e.g. Wisconsin Hydro-Electric Co.*, 10 B. T. A. 933; *El Paso Electric Railway Co.*,

10 B. T. A. 79; *Tampa Electric Co.*, 12 B. T. A. 1002); and the respondent has acquiesced. See *G. C. M. 1581*, VI-1 C. B. 197; *G. C. M. 16952*, 1937-1 C. B. 133. Both kinds of contributions were involved in *Edwards* v. *Cuba Railroad Co.*; and this Court specifically said they should be treated alike.

So here, the result is the same whether the petitioner be said to have made a capital investment in the extensions equal to the cost of construction or whether it be deemed in effect to have received them without making any personal investment and to have taken over the contributors' costs.

(2)

Assuming petitioner personally made no capital investment in the line extensions, it by no means follows that it suffers no current economic loss through depreciation subject to depreciation allowances under Section 23(l).

An owner of depreciable property actually suffers a current economic loss on that property due to the passage of time, however he may have acquired it, unless of course someone undertakes to make it good. The extent of the economic loss in any year is the amount by which the property depreciates in value during the year. Thus, if Section 23(l) presupposes an economic loss, such a loss is clearly present here. For petitioner has full ownership of the line extensions: they depreciate in value year by year through exhaustion, wear and tear; and petitioner suffers that loss since no one has covenanted to make it good. The cases relied upon by respondent are beside the point. None of them involved gifts or contributions to capital. *United States* v. *Flannery*, 268 U. S. 98, dealt with

a peculiar situation, confronted at the outset of the income tax law, in which a loss was claimed on property that had appreciated, not depreciated, in value; there no output of money had been made by anyone and no actual loss was suffered in respect of the appreciation. *Weiss* v. *Weiner*, 279 U. S. 333, and the other lease cases cited, dealt with lessees who had no present property interest to depreciate beyond their own investment or with lessors who suffered no depreciation because the lessees agreed to stand the loss—all distinguishable for the reasons given at page 34 of petitioner's main brief.

Respondent's argument that an out-of-pocket capital investment is necessary in order to obtain a depreciation deduction under the broad provisions of Section 23(l) runs squarely against the plain provisions of the statute that a donee may take depreciation.

If Jones gives Smith a plant or the money with which to build it, would Smith make a profit if he sold it at once? No, because the statute says so. The statute gives him Jones' cost.

If Smith operates the plant, does he get current deductions for depreciation currently suffered? Yes, because the statute says so. Depreciation being in substance a sale of property through use, the statute says Smith shall have Jones' cost for depreciation purposes also.

It is not believed respondent would attempt to question this. Yet Smith has made no more of a capital investment in the plant, and suffers no greater economic loss through depreciation—perhaps less, since the law would impose on him no legal obligation to maintain and replace—than does the petitioner with respect to the line extensions here. Though Smith "obtains not simply the *future* obligation of

another to make good any [depreciation] loss which might result, but obtains instead . . . the actual present assumption of that loss by another" (p. 17), he is not *a fortiori* denied depreciation deductions. On the contrary, he concededly gets such deductions under the statute.

The case at bar, though seemingly more complicated because we are dealing with regulated utility procedures, is fundamentally as simple as that in this illustration. The only other factor in either case is the effect of the motives of the contributor or of any resulting obligations incurred by the recipient, but these factors do not affect the right to depreciation under Section 23(1). They bear only upon whether the contributions, be they in money with which to build the property or in the property itself, were purchased for a consideration, in which event the purchase price would be the depreciation basis, or constituted income, gifts, or contributions to capital, in which event the basis would be the cost of construction.

If Congress had intended that a taxpayer, in order to get depreciation deductions, had to put his own money into the property, it could readily have so provided. But instead of so doing, it has carefully provided that a transferee of property without consideration takes over the cost basis of the transferor and is to be allowed depreciation on that.

(3)

Respondent passes lightly over the status of the contributions as gifts or contributions to capital. He simply says (p. 21) *a fortiorari* they were not gifts because not mere gratuities but paid to secure services which the contributors

would not otherwise be entitled to receive.[1] Relying upon *Edwards v. Cuba Railroad Co.* for his statement as to the non-gratuitous character of the contributions, he cites but fails to discuss this Court's recent decision in *Helvering v. American Dental Co.*, No. 303 this Term, decided March 1, 1943, which strongly reinforces petitioner's view that the contributions, whether or not gratuitous in the sense of donative or altruistic motive, were nevertheless gifts or contributions to capital because received without consideration.

When he comes to contributions to capital, respondent, while not denying that they may be made by nonstockholders, seeks to remove the contributions here from that category chiefly because they did not become part of "those resources whose dedication to the users of the corporation is made the foundation for the issuance of capital stock and which, as the result of the dedication, become irrevocably devoted to the satisfaction of all the obligations of the corporation" (pp. 25-26). If by this it is intended to suggest that there can be no capital contribution unless it be made

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[1] Respondent intimates in footnote 6 (p. 22) that the contributions, though paid regardless of the actual rendering of any service, and despite petitioner's legal obligation to maintain and replace, might have been taxable as income on the theory that they were given "as advance payment for services to be rendered". This of course, while not material to this case, is not strictly true. Indeed, it is less true here than in *Edwards v. Cuba Railroad Co.* where the contributor obtained direct contractual rights to reduced rates and other special privileges. Here petitioner's obligations following construction of an extension arose by operation of law. They were simply resulting legal duties imposed on it by law because it is a public utility corporation. Though the purpose of the contribution was undoubtedly to put the contributor in a position in relation to the enterprise whereby he could obtain service on demand at regular rates, petitioner's service obligations run equally to everyone in the territory adjacent to the line extension since it becomes part of its expanded distribution system.

the basis for a stock issue, the suggestion is clearly wrong. The statute, Section 113 (a)(8)(A) and (B), refers to transfers in exchange for stock, to contributions to paid-in surplus and to contributions to capital; and each must be given effect. If the statement simply means that the thing contributed must become a company asset, that factor is present here. And finally, the requirement that the contribution be irrevocably devoted to the satisfaction of all petitioner's obligations is open to serious question. As to this requirement, one of two alternatives seems inescapable. (a) If mechanics are controlling, the test is met, though we need not be concerned with it. For the cash contributions though given for a capital purpose were not earmarked and became available to petitioner for any use whatsoever, it having constructed the extensions out of its general working funds at a cost equal to the amount expended. (b) If substance is controlling, the test is also met as fully as can ever be the case with a contribution of property in kind. Precisely as in the case of a contribution of a line extension itself, the cash with which to build one is contributed in order to bring about an addition to the permanent capital assets of the petitioner. The purpose being to contribute something to the permanent capital of the enterprise, the requirements of a capital contribution contemplated by Section 113(a)(8)(B) of the statute and Article 113(a)(8)-1 of Regulations 94 are fulfilled. Considering the company as an economic unit, there can be no distinction in this regard between contributions by stockholders and third parties.

The second alternative represents the view expressed by this Court in *Edwards* v. *Cuba Railroad Co.*, which respondent fails to refer to in connection with this point. In-

deed, in that case this Court pointed out that the very fact that the contributions were intended to be used for capital purposes and not for dividends, operating expenses and the like was a controlling reason why they were contributions to capital and not income. *Cf.* Some Indicia of Capital Transfers Under the Federal Income Tax Laws, 37 Mich. L. R. 745; Mertens, Law of Federal Income Taxation, 1939 Cumulative Supplement, par. 5.32A, page 89. This view was reaffirmed by this Court in 1932 in *Texas & Pacific Railway Co.* v. *United States*, 286 U. S. 285. In holding certain payments under Section 209 of the Transportation Act of 1920 to be income, this Court there distinguished the *Cuba Railroad* case by saying (p. 289):

> "The sums received under the act were not subsidies or gifts,—that is, contributions to the capital of the railroads,—and this fact distinguishes cases such as *Edwards* v. *Cuba Railroad Co.* * * *, where the payments were conditioned upon construction work performed. Here they were to be measured by a deficiency in operating income, and might be used for the payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied."

In the Board cases involving non-taxability of third party contributions, the contributions appear to have been regarded as gifts or contributions to capital since they were not income, irrespective of whether they were made in money with which to erect property or in the property itself. In the leading case of *Liberty Light & Power Co.*, 4 B. T. A. 155, for example, it was said that the contributions "were contributed by the citizens to the capital of the

taxpayer";[2] and in this and other decisions following it respondent has acquiesced. Indeed, respondent's general counsel has publicly consistently described such contributions as gifts or contributions to capital. *G. C. M. 1581*, VI-1 C. B. 197 (1927), and *G. C. M. 16952*, 1937-1 C. B. 133.[3]

No other alternative is possible. The purely adjective provision, Section 113(b)(1)(A), which the Court below brought into play with respect to the cash, and which could not possibly apply to property contributions for identical purposes, is not controlling for the reasons set forth in petitioner's main brief (pp. 29-32). These reasons respondent has not even attempted to meet.

(4)

Respondent complains of a double benefit, urging that since the contributions were not taxable, consistency in treatment requires that depreciation be disallowed on the contributed property in order to reflect petitioner's true

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[2]While *Frank Holton & Co.*, 10 B. T. A. 1317, and *Tampa Electric Co.*, 12 B. T. A. 1002, held that such contributions did not become part of invested capital under the war profits and excess profits tax laws of 1918 and 1921, that was because those laws, differing from the present income tax and excess profits tax laws, specifically defined invested capital in Section 326(a) as including only amounts paid in for shares and paid-in surplus. Contributions to capital and gifts were not taken into account.

[3]In footnote 6, respondent refers to private information received from unnamed sources with respect to past Treasury practice. Petitioner has no opportunity to ascertain whether the information is authoritative or represents half truths or whole truths. But it seems evident, from the inquiries that have been made of it and the interest shown by other taxpayers in this case, that, like the petitioner, others similarly situated do not acquiesce in the Treasury's current position.

income (pp. 22, 26). He thus in effect seeks to renew the old fight over the taxability of third party contributions. For the reasons given under Point III of petitioner's main brief, there would be no resulting double benefit here; but even if there were, the question of double benefit is wholly irrelevant. In the last analysis, respondent's real complaint is that the tax statute allows taxpayers to receive property without consideration and still take depreciation on it. In reality this is no different from giving a taxpayer a basis for property for which he paid nothing in determining the tax consequences of its sale, which the Revenue Act also does.

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